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Nos. 78, 79.

In the

Supreme Court of the United States.

October Term, 1935.

GUY T. HELVERING, Commissioner of Internal Revenue, *Petitioner*,

v.

COLEMAN-GILBERT ASSOCIATES.

BRIEF FOR RESPONDENT, COLEMAN-GILBERT ASSOCIATES.

Opinions Below.

This case comes here from the Circuit Court of Appeals for the First Circuit, whose decision is reported in 76 Fed. (2d) 191, reversing the decision of the United States Board of Tax Appeals reported in 30 B.T.A. 1463.

Jurisdiction.

This case is here on certiorari granted by the Court October 14, 1935 (R. 48).

Question Presented.

The question is whether Coleman-Gilbert Associates is an association, taxable as a corporation.

Statutes and Regulations Involved.

The statutes involved are the Revenue Act of 1926, c. 27, 44 Stat. 9, sec. 2 (*a*) (2); the Revenue Act of 1928, c. 852, 45 Stat. 791, sec. 701 (*a*) (2). These statutes are set out at length in Appendix hereto. The Regulations involved are Regulations 62, article 1504, Regulations 69, articles 1502 and 1504, and Regulations 74, articles 1312 and 1314.

Statement.

Facts additional to those set out in the statement of the Government counsel in brief are as follows:

The apartment houses involved and constituting the assets of the trust had been owned and operated for some time prior to the formation of the trust by the five trustees as tenants in common (R. 15, 18 and 22), three of them being the active operators (R. 23 and 24). After the formation of the trust, the respective equitable interests of the five individuals as beneficiaries were identically the same as when they were tenants in common of the properties (R. 11 and 22). The properties were handled the same after the formation of the trust as before, and there was no change in the books (R. 24). The trustees never held any meetings or kept any records of trustees' proceedings, and no salaries were paid the trustees, two of whom devoted their whole time to the trust affairs (R. 23 and 24).

The purpose of forming the trust was to prevent a partition of the property by some of the heirs of the tenants in common in case of the death of any one of them, and the trust instrument specifically precluded a partition (R. 24 and 9). The provision giving the trustees power to purchase other property was simply to protect the property of the trust in case of need, and was a power that was never exercised (R. 24).

The trust was limited to a duration of fifteen years, at the end of which time the property must be sold and the proceeds distributed, and the trustees could at any time within said period sell the property and terminate the trust (R. 8 and 12). The trustees could at any time alter the terms of the trust except that they could not extend it beyond fifteen years (R. 12). Pending the termination of the trust, the net profits and any surplus realized from sales were distributable to the beneficiaries (R. 10).

There was no provision for other than the unanimous action of all the trustees in all affairs of the trust, and there were no certificates of beneficial interest issued or provided for (R. 8, 12 and 18).

Summary of Argument.

The facts that were before the Board of Tax Appeals and the Circuit Court of Appeals permit of only one conclusion, namely, that Coleman-Gilbert Associates were not operating in quasi-corporate form and were not an association within the meaning of said Revenue Acts.

Argument.

In the case of *Hecht* v. *Malley*, 265 U.S. 144, this Court said, at page 157:

> "The word 'association' appears to be used in the Act in its ordinary meaning. It has been defined as a term 'used throughout the United States to signify a body of persons united without a charter, but upon the methods and forms used by incorporated bodies for the prosecution of some common enterprise.' 1 Abb. Law Dict. 101 (1879); 1 Bouv. Law Dict. (Rawle's 3d Rev.) 269; 3 Am. & Eng. Enc. Law (2d ed.) 162; and Allen v. Stevens, 33 App. Div. 485, 54 N. Y. Supp. 8,

23, in which this definition was cited with approval as being in accord with the common understanding. Other definitions are: 'In the United States, as distinguished from a corporation, a body of persons organized, for the prosecution of some purpose, without a charter, but having the general form and mode of procedure of a corporation.' Webst. New Internat. Dict. '[U.S.] An organized but unchartered body analogous to but distinguished from a corporation.' Pract. Stand. Dict."

In the case at bar, five tenants in common of certain parcels of real estate, in order to preclude any partition of their respective undivided interests for at least a period of fifteen years, entered into a written agreement calling themselves trustees, under the name of "Coleman-Gilbert Associates," of the property owned by them. This agreement bound all five to concerted action in respect of the property and required the disposal of it within fifteen years. There was no change in the method of handling the property, the same three who had been active continuing to be the active members of the group as theretofore. There was no change in the keeping of the books of account and no change in the proportionate beneficial interests. No remuneration was paid to any of the five for services, and there were no formalities of meetings or records other than regular books of account, which were the same as had always been kept. There were no certificates issued or anything to represent the respective interests of the five in the property after the trust was formed, different from what had previously existed.

There was no semblance to corporate organization or procedure in Coleman-Gilbert Associates. The trustees could take action only as a unit, as there was no majority control provided for. Unlike directors of a corporation,

but more like partners, the trustees could modify or terminate the provisions of the instrument under which they functioned. The agreement of trust created what amounted to an operating arrangement among the tenants in common in respect of the property so held more in the nature of a partnership than in the nature of a corporation.

The fact that the beneficiaries of the trust by the provisions of the trust instrument are exempted from personal liability is the ordinary legal consequence that follows in the case of any trust, as the general rule is that beneficiaries are not personally responsible for claims arising from operation of the trust property, and this provision in itself cannot be said to create a resemblance to a corporate organization as distinguished from a trust. (See American Law Institute "Restatement of Law of Trusts," vol. II, sec. 274.)

No more does the fact that the beneficiaries of the trust could, in the absence of specific prohibition, assign their interests have any tendency to create a resemblance to a corporation, as, in the case of most pure trusts, the beneficial interests are assignable at will.

The provision that the interests of the beneficiaries of the trust should be personalty and not treated as realty does not lead to the conclusion that this was a feature peculiarly characteristic of a stock interest in a corporation rather than an interest in a realty trust. The realty in this case was held for purposes of sale, the trust instrument specifically providing for its sale not later than fifteen years from date and the beneficiaries' interest was limited to the rents and profits during the period of the trust existence, with a right to distribution of the proceeds of the sale at the termination of the trust. The general rule is that, in cases of trusts of real property with such provisions, the interests of the beneficiaries are treated as per-

sonal property rather than real property. (See American Law Institute "Restatement of the Law of Trusts," vol. I, secs. 130 and 131.)

We have here a situation where tenants in common, holding both the legal and equitable interests in real estate, declared themselves common trustees of said property for their own benefit. The legal effect when these tenants in common respectively conveyed their respective undivided interests in the real estate to all five of themselves as trustees for the benefit of themselves in exact proportion to their previous undivided interests was to put the legal title in the five as joint tenants and the equitable interests (if they had continued as interests in realty rather than personalty) remained as tenancies in common.

As is said in the "Restatement of the Law of Trusts," adopted and promulgated by the American Law Institute, vol. I, sec. 99 (*b*):

> "On the other hand, there can be a trust where there are several beneficiaries who are also the trustees. In such a case each of the beneficiaries has an equitable interest which is separate from the legal interest held by the whole group. As trustees they hold the legal title as joint tenants, and ordinarily they hold the beneficial interests as tenants in common. No one of them, without the concurrence of the others, can properly transfer an undivided legal interest in the property free of trust. If a creditor of one of the beneficiaries seeks to reach his interest he can do so only by proceedings appropriate for reaching an equitable interest, and cannot levy execution in an action at law upon his legal interest."

It is contended that the provision in the Declaration of Trust that there shall be no personal responsibility of the

trustees to third parties partakes of the corporate character. A trustee can always, in making a contract in behalf of the trust, limit liability to the trust estate. The insertion of a general provision to that effect in the trust instrument is of no effect whatever upon third parties unless they have knowledge, either actual or constructive, of the existence of the limitation and enter upon the contract with such knowledge. The effectiveness of the limitation, in other words, is dependent upon its being one of the terms of each contract when made by the trustee with a third party. (Restatement of the Law of Trusts, vol. II, sec. 263.)

Any powers of the trustees under the instrument of trust extending beyond the administration and disposal of the specific property conveyed to the trustees were inserted merely as precautionary and protective provisions, and were never exercised, and have no significance to determine the character of the Coleman-Gilbert Associates. *Commissioner* v. *Pryor & Lockhart Development Co.*, 70 Fed. (2d) 154, 158. *Gardiner* v. *United States*, 49 Fed. (2d) 992.

The Court below quoted pertinent language in the opinion in *Commissioner* v. *Pryor & Lockhart Development Co.*, *supra*, as follows (R. 43):

> "Where an entity of this kind resembles a corporation in some respects and that of a partnership in others—that frequently being the case—the features of similarity should be compared and the marks of dissimilarity contrasted. The resemblances should be balanced. It should be determined by that method the one to which the enterprise is predominantly akin in the method, mode, and form of procedure in the conduct of its business. If it be a corporation, it fall within that category; if a partnership, it should be placed in that class and should be taxed accordingly."

Referring to the contention that the regulations of the Treasury Department should have a controlling effect, these regulations, as the Court below pointed out, have been changed from time to time and have not followed closely the language of the courts, and it is not reasonable to assume that Congress adopted each change in the regulations without at any time changing the language of the various Revenue Acts adopted.

The provision in Regulations 69, art. 1504, that, "Even in the absence of any control by the beneficiaries, where the trustees are not restricted to the mere collection of funds and their payment to the beneficiaries, but are associated together with similar or greater powers than the directors in a corporation for the purpose of carrying on some business enterprise, the trust is an association within the meaning of the statute," would result in many trusts established by testamentary provisions being held to be associations under the Revenue Acts.

A test here is whether the trustees were "conducting business after the mode and manner of a corporation" or "doing nothing more than trustees ordinarily would be called upon to perform in the management of trust property." *Lansdowne Realty Trust* v. *Commissioner,* 50 Fed. (2d) at 58.

Speaking of the activities of the trustees, the Court below in its opinion said (R. 44 and 45):

> "The three active members of the trustees were undoubtedly conducting the management of the trust property with a view to ensuring an income for the beneficiaries of the trust, who were the equitable if not the legal owners of the res; but it does not appear that they exercised any powers that they were not bound to exercise by reason of their ordinary duties as trustees in preserving the properties under a pure trust, viz: keeping them in repair, renting them to the best

advantage, and collecting the rentals, and paying operating expenses. In other words, they did nothing that they were not bound to do in their capacity as trustees, if the trust was what may be termed a pure trust, in which the trustees were expressly authorized to borrow money, if necessary, for carrying out the purpose of the trust.

"From the activities of the trustees alone we do not think the Board was warranted in holding as a matter of law that the trust was an association. While there may have been sufficient evidence to warrant the Board in finding that they were conducting a business enterprise, and with the purpose of ensuring an income for the beneficiaries during the continuance of the trust, and while they may have exercised powers in some respects as great as those of the directors of a corporation, they did not exercise them in the manner of directors of a corporation. They held no meetings; they kept no records; their acts were not determined by a majority vote. Their tenure as trustees was during life or the duration of the trust, unless they voluntarily resigned. Two trustees were wholly inactive, and a third only active in part in the management. They conducted the business in the same manner that it had been conducted before the trust was formed.

"In a case not clearly falling on one side or the other of the line between an association and a trust, we think the Board in comparing the resemblance of a trust to a corporation, should give due weight to the purpose for which the trust was organized. The uncontradicted evidence in these cases discloses, we think, that the Coleman-Gilbert Association was not organized to conduct a business for profit; that while the trustees did manage the property so that it produced an income for the beneficiaries, it was only in-

cidental to the main purpose for which the trust was created. The purpose of the creators, according to the uncontradicted evidence, was to prevent a partition and division of the property in case one of the owners died within a definite period of time. It was deemed in the interest of the coowners and their heirs that the properties should be kept intact for a period of fifteen years. There is no evidence to warrant any inference that it was organized in order that it might be better managed, or that any additional financial advantage would accrue from creating a trust. If every trust terminating in five, ten or fifteen years in which the trust res consisted of rentable real estate is managed faithfully and prudently by the trustees with a view to producing the largest income for the cestuis qui trustent is to be taxed as an association, few strictly pure trusts would escape a double taxation upon its income."

The Government stresses the so-called "business test" as a determining factor in classifying a trust as an association. It is submitted that what business a trust is doing is essentially immaterial; that the material inquiry is: How is the trust carrying on its operations? In the case of *Hecht* v. *Malley, supra,* the Court necessarily inquired into whether or not the trust there involved was engaged in carrying on business, as the statute under consideration was an excise tax imposed on the privilege of doing business. The case at bar involves the imposition of an income tax on corporations, a term which, by the provisions of the Act, also includes associations. This tax is imposed upon all corporations and associations (excepting only certain specified classes) regardless of what their business may be and regardless of whether or not they are carrying on the business for which they were organized. It is im-

posed upon all gains, even those that might result from liquidation proceedings. Such being the statute involved, it would seem to be immaterial to inquire whether a corporation or an association were actually engaged in ordinary business operations or otherwise.

The only instance where the nature of the activity of the trust might be material would be where such activity could not be exercised through the corporate form and method, and in such case there would be no issue.

The test that should be applied to determine whether a trust is to be treated as an association is to ascertain whether in its mode and method of procedure it is following to a substantial degree the mode and method used by incorporated bodies. To point out that the trust has certain characteristics such as continuity, freedom from personal liability and centralized direction in its affairs, which are also the characteristics of corporations, as a proof of the existence of an association rather than a trust, is begging the question. Those common characteristics have been features of trusts since long before corporations were created by statute, and merely demonstrate that corporations have some of the characteristics of trusts. To make a trust an association, it must have in its structure or method of operation to a substantial degree those elements which are peculiar to corporations as distinguished from trusts. Such corporate elements are not found in Coleman-Gilbert Associates.

The decision of the Circuit Court of Appeals should be affirmed.

Respectfully submitted,

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APPENDIX

Revenue Act of 1926, c. 27, 44 Stat. 9:

"Sec. 2 (*a*) When used in this Act—

* * * * * * * *

"(2) The term 'corporation' includes associations, joint-stock companies, and insurance companies."

(U. S. C. App., Title 26, sec. 1262.)

Revenue Act of 1928, c. 852, 45 Stat. 791:

Sec. 701 (*a*) (2) is identical with section 2 (*a*) (2) of the Revenue Act of 1926, *supra*.

Regulations 62, promulgated under the Revenue Act of 1922:

"Art. 1504. Association distinguished from trust. Where trustees hold real estate subject to a lease and collect the rents, doing no business other than distributing the income less taxes and similar expenses to the holders of their receipt certificates, who have no control except the right of filling a vacancy among the trustees and of consenting to a modification of the terms of the trust, no association exists and the cestuis que trust are liable to tax as beneficiaries of a trust the income of which is to be distributed periodically, whether or not at regular intervals. But in such a trust if the trustees pursuant to the terms thereof have the right to hold the income for future distribution, the net income is taxed to the trustees instead of to the beneficiaries. See Section 219 of the Statute and Arts. 341-348. If, however, the cestuis que trust have a voice in the conduct of the business of the trust, whether through the right periodically to elect trustees or otherwise, the trust is an association within the meaning of the statute."

Regulations 69, promulgated under the Revenue Act of 1926:

"Art. 1502. Association. Associations and joint-stock companies include associations, common-law trusts, and organizations by whatever name known, which act or do business in an organized capacity, whether created under and pursuant to State laws, agreements, declarations of trust, or otherwise, the net income of which, if any, is distributed or distributable among the shareholders on the basis of the capital stock which each holds, or, whether there is no capital stock, on the basis of the proportionate share or capital which each has or has invested in the business or property of the organization. A corporation which has ceased to exist in contemplation of law but continues its business in quasi-corporate form is an association or corporation within the meaning of section 2."

"Art. 1504. Association distinguished from trust. Where trustees merely hold property for the collection of the income and its distribution among the beneficiaries of the trust, and are not engaged, either by themselves or in connection with the beneficiaries in the carrying on of any business, and the beneficiaries have no control over the trust, although their consent may be required for the filling of a vacancy among the trustees or for a modification of the terms of the trust, no association exists, and the trust and the beneficiaries thereof will be subject to tax as provided by section 219 and by articles 341-347. If, however, the beneficiaries have positive control over the trust, whether through the right periodically to elect trustees or otherwise, an association exists within the meaning of section 2. Even in the absence of any control by the beneficiaries, where the trustees are not restricted to the

mere collection of funds and their payment to the beneficiaries, but are associated together with similar or greater powers than the directors in a corporation for the purpose of carrying on some business enterprise, the trust is an association within the meaning of the statute."

Regulations 74, promulgated under the Revenue Act of 1928:

Articles 1312 and 1314 are substantially the same as articles 1502 and 1504 of Regulations 69, *supra*.